OPERATIONS, CONTROLS AND AUDITS

A. INTRODUCTION

The operations section of a trust department provides support to the administrative arm in much the same way as the operations division of a bank supports its other functions. As such, it is the focal point for all actions affecting customer accounts and the department itself. To be effective it must provide management with accurate and reliable systems for documentation, accounting and control. While the sophistication of the operational systems employed is likely to vary proportionately with the size and complexity of the department, the underlying principles involved are universal. Documentation substantiating appointments and actions taken throughout the life of an account must be obtained and preserved, recordkeeping systems must provide a detailed picture of all funds and properties coming under the control of the fiduciary from an account's inception to its closing, procedures must be developed to process work in a uniform and orderly manner, and a practical system of checks and balances must be developed to ensure the integrity of work performed.

B. TRUST ACCOUNTING

While general accounting principles apply to trust recordkeeping, significant differences exist between the accounting systems employed by the trust department and commercial banking division. These differences arise by virtue of the nature of the accounts administered and the legal obligations imposed upon fiduciaries. Trust departments are called upon to serve in various capacities. Aside from personal trusts, the department may serve as corporate trustee for bond issues or as a paying or escrow agent. Since each account must be treated as an individual entity, the accounting system adopted will be required to reflect individual statements of condition or accountability as well as aggregate controls for the department. The specialization required by this type of system and the legal ramifications involved in handling fiduciary matters necessitate adoption of a completely separate set of books and records.

The fundamental principle behind general accounting theory is expressed in the equation - <u>Assets = Liabilities + Capital</u>.

This principle does not apply to trust since the fiduciary does not account for its own assets but rather, for the property of others. As such, the fundamental principle behind trust accounting is expressed as follows - <u>Assets = Accountability (or Liabilities)</u>. In this equation, assets such as securities, deposits, or real property are liabilities that the department is accountable or liable for to others. Expressed differently, assets of trust accounts are liabilities of the department. Normally, the only accounts holding cash or assets not owed to fiduciary customers will be so called "house accounts", which may include undistributed profits and suspense items.

C. PROPERTY OWNERSHIP

Property law differs between states and examiners should have some basic knowledge of the property law incidental to their applicable states. However, it should be noted that real property is governed by the laws of the state in which it is located. Trusts in some form are permissible in all states. A trust occurs when the ownership of property is separated as to title and equity. A trustee retains title to trust property (corpus) but has no beneficial or equitable interest in the corpus. A trust cannot exist when the legal owner or party who has title also holds the beneficial interest. Nevertheless, a fiduciary does not necessarily have to hold property title, e.g., a guardianship. Beneficiaries are divided into two classes, those that have a current interest in the trust corpus and those that have a remainder interest. Since the first class of beneficiaries are entitled to the return generated from the corpus while the remainder are entitled to the value of the corpus (including gains and losses) at termination, the trustee must maintain separate records of income and principal.

In an agency capacity, ownership and, in general, title to the assets, do not pass to the trust institution but remain with the principal. The bank's obligation is to act as the principal's agent and follow instructions stipulated in the agreement.

D. PRINCIPAL AND INCOME

For reasons mentioned above, an important concept in fiduciary accounting is the distinction between principal and income. Simply stated, principal (corpus) consists of cash and other property transferred to the fiduciary. Income is the return derived from the principal and may be distributed as cash or reinvested for the trust account and held as invested income. Separate records of principal and income are customary and often required for accounts other than trusts because they facilitate preparation of accountings and tax returns. Many states have adopted a uniform principal and income act covering the treatment of various items.

E. CARRYING VALUES

Unlike commercial bank accounting where assets and liabilities are carried at cost or book value, there is no generally accepted system for assigning carrying values to assets held by trust institutions. The examiner may find that the assignment of carrying values will vary, not only from institution to institution but also from one type of account to another within the same trust department. This makes difficult if not impossible any meaningful analysis of a trust department's statement of condition before adjustment. In general, assets will be carried at values in one of the following manners: Book or cost of the asset when purchased or tax valuation when acquired from an estate; Par, the face value of the property; or Nominal, a nominal value assigned to each issue or interest of ownership held.

It is common to find stocks and real property carried at cost; bonds, capital notes and commercial paper carried at par; and miscellaneous property such as insurance policies, indentures or other documents carried at nominal value. It is also common to find stocks carried at a nominal value for the number of shares held, particularly in custody or safekeeping accounts.

F. ACCOUNTING RECORDS

As mentioned earlier, the sophistication of departments varies. Records will also vary since, in addition to differences relating to size and character of accounts administered, trust accounting systems are not standardized. However, reporting requirements imposed on fiduciaries and the concepts involved remain the same. Therefore, the overall framework of each accounting system consists of the following:

<u>General Ledger</u> - The general ledger will be comprised of all control accounts of the department. It includes both customer and internal accounts used by the department to facilitate its operation. Many automated systems have subsidiary control records but do not have the traditional general ledger. The examiner must exercise judgement in determining the sufficiency of these records when they are encountered.

<u>Asset Control Accounts</u> - These accounts should reflect total holdings of major asset categories, such as stocks, bonds or deposits.

<u>Subsidiary Asset Controls</u> - These accounts will reflect total investments in specific issues of stocks, bonds, etc.

<u>Subsidiary Liability Controls</u> - These accounts will reflect the total of cash and investment holdings of each type of account administered. This category should be further subclassified to allow the department to post transactions to individual accounts; Cash ledger should detail income and principal cash and reflect transactions in chronological order, and Investment ledger should reflect each asset held by a trust account. Purchases, sales, stock dividends and splits should be recorded in chronological order. The examiner must bear in mind that some indentures provide for the reinvestment of income cash. In these situations it will be necessary to maintain separate ledgers to account for these assets.

G. TRUST RECORDS

In addition to maintaining a sensibly organized and reliable system of accounting, a trust department will need to create other records to administer its accounts in a timely and cost-effective manner. The design and control of these support records can mean the difference between a department which functions smoothly and one which has to search through unorganized data each time administrative actions need to be taken. Moreover, departments possessing carefully prepared and maintained records are less likely to suffer ill effects from personnel turnover, errors in judgment and incurring contingent liabilities. Two such records of paramount importance are the Administrative File and the Tickler System.

Administrative File - The administrative file or folder is the single most useful record to which trust department personnel and the auditor are likely to refer during the term of an account. This document actually consists of a number of interrelated records which, as a whole, represent a living history of an account. They may be held in a single file or found in several different locations within the department. These records consist of:

(1) Legal File - Contains copies of all legal documents relevant to the account and will include document which created the account, such as a will, an agreement or court order.

(2) Digest or Synopsis - Highlights principle duties and provisions of the legal document which created the account and may also provide statistical data such as beneficiaries, remaindermen, remittance instructions and reporting requirements. This record is especially valuable to trust management and administrative officers alike.

(3) Correspondence File - Contains all correspondence related to the account.

(4) Investment Review File - Contains asset reviews which enable management to evaluate its investment performance.

(5) Securities Transaction File - Contains broker confirmations and other data related to each asset change during the life of the account

(6) Tax File - Contains tax-related documents and copies of tax returns filed for the account.

Tickler System - Administering accounts calls for timely attention to routine and recurring tasks. The administration of numerous accounts, each having its own particular servicing requirements, necessitates adoption of a uniform system of control to ensure the performance of duties. A tickler system is nothing more than a chronologically arranged system of records which remind the department to collect income, distribute funds, calculate trust fees, etc. Though simple in design and concept accuracy and effective use of its contents can be critical for account administration.

Other records which affect the operation of a department to a significant degree and which an examiner will find useful in the examination process are:

(1) Securities Transaction Register - This record should list in chronological order all securities transactions effected by the department. The preparation and content of this document as well as other records pertaining to securities transactions are regulated by Part 344 of the Corporation's Rules and Regulations.

(2) Vault Control Log - This log records the dates and identities of individuals who accessed the departments vault. Records should also be maintained indicating the securities accessed and reasons therefore.

(3) Broker Statements - Similar in some respects to deposit account statements, these reflect all transactions effected for the department by its brokers. These statements should be reviewed carefully by the department and reconciled to broker confirmations and the bank's Securities Transaction Register.

H. Documentation

Properly documenting the administration of an account is as important as the administration itself because fiduciaries must account for their actions to others. Failure to support actions taken or provide rationale therefore may result in court imposed surcharges or negotiated loss settlements. In a trust examination, examiners will encounter two basic types of documentation; the first evidences the fiduciary's appointment and creation of the account, and the second supports actions taken by the fiduciary during the term of the account.

Evidence of Appointment - In general, a fiduciary should refrain from taking any action until it receives proper evidence of appointment and an original or authenticated copy of the instrument creating the account. Valid evidences of appointment depend upon the type of appointment. In the simplest of appointments, such as a personal agency, the department need only execute an agreement with its customer. The same holds for a living trust. In accounts operating under court jurisdiction, such as estates, trusts under will and court appointed guardianships, the fiduciary will need to obtain a court order of appointment in addition to the instrument creating the account. In estates where the executor has been named in the will, the court appointment is called Letters Testamentary. In estates where named executors cannot or do not accept appointment, a court will appoint an administrator for the estate under Letters of Administration. Letters of Administration are also used to appoint an administrator where no valid will exists. Trustees named in a will serve under Letters of Trusteeship. Guardians serving under court appointment are issued Letters of Guardianship. In corporate appointments, the fiduciary should obtain a resolution appointing it to serve as well as a copy of the instrument it will be serving under. In accepting appointments to serve as successor to a prior trustee or executor, the fiduciary should obtain copies of the original court appointments (if applicable), an authenticated copy of the instrument it will serve under, an accounting of the estate, trust or agency from inception to its appointment and any other documents which would substantiate its appointment or indemnify it against the actions of others.

Supporting Documentation - During the term of an account, countless actions may be taken to serve the needs of the account and its beneficiaries. At times these actions involve nothing more than processing an address change for an income beneficiary. Others may involve actions having serious consequences for the account, such as principal invasions or selling assets at a capital loss. A fiduciary must be able to support its actions by demonstrating it had the legal authority and exercised sound reasoning. The fiduciary's legal authority will be found in the common law, statutory law and the underlying indenture. Its rationale for taking action may be more difficult to demonstrate, therefore, it is essential the fiduciary support its actions with documentation. The types of documentation the fiduciary will need to develop are:

(1) Trust Committee Minutes - Deliberation and action over matters affecting the account.

(2) Approvals - Written approvals for discretionary action are sometimes required by indentures and other times merely prudent. Written approvals should always be sought from co-fiduciaries. When extraordinary actions affect individuals having a future interest in an account, the fiduciary should seek written approvals from remaindermen.

(3) Indemnification - Certain discretionary actions involve controversial matters, such as purchasing own-bank or parent securities or performing duties not specified in trust indentures but requested by others such as co-fiduciaries or remaindermen. These actions require more formalized written approvals in the form of agreements or court rulings indemnifying the fiduciary against loss.

(4) Accountings and Customers' Statements - These are required for court appointed accounts but commonly prepared for other types. Essentially, they reflect in report form all transactions of the account occurring within a specific period of time. Accountings should be approved by either the court having jurisdiction, all interested parties, or both.

(5) Account Reviews - Periodic reviews performed by the trust committee.

(6) Receipt and Release - This is a formal document acknowledging receipt of cash or assets. It is given by the recipient to the fiduciary and releases the fiduciary from any further obligation with respect to a bequest or other distribution.

(7) Other Documents - There are numerous documents a fiduciary will obtain during the administration of an account. These might include; property appraisals, lease agreements, broker confirmations, receipts for work contracted, or investment research. Each has its own significance and, depending on the nature of the appointment, may serve to support fiduciary actions.

I. INTERNAL CONTROLS

A basic concept of internal controls is that control can best be achieved through a division of duties. In effect, no individual should be permitted to both initiate and follow through any transaction. In a trust department, this concept begins by segregating administrative from operational functions, and continues by segregating duties within the operating system itself. Careful analysis will be needed for the department to develop an economically practical system of internal controls. It is the responsibility of management to assess the nature and specific requirements of its department and based upon this analysis prescribe an overall system of policies, practices and procedures. It is the responsibility of the examiner to evaluate the adequacy of these policies and procedures and observe whether or not they are being enforced.

Elements of Control - Control has as its basis the organizational structure of the department. Management must first define its functional lines of responsibility and establish an organizational framework along those lines, following which it will be necessary to design logical patterns of work flow. These procedures should take into consideration the need for checks and balances and the design of an efficient, practical system. It will be necessary to review control systems and update them accordingly. Although systems will vary from institution to institution, each control system should encompass the following in some form: Adoption of a comprehensive operations manual; Provide for surprise audits (internal and external); Periodic verification of asset;

Segregation of trust assets from bank assets (physical and accounting); Dual control over trust assets; Exercise of vault control procedures, recordation of access and asset transfers; Daily proof of transactions (balancing and closing routine); Review and signing of transaction journals by administrators; Maintenance of accounting records on a current basis; Dual signature requirements for checks; Requirements for documentation authorizing asset changes, cash distributions, and large overdrafts; Use of prenumbered documents in sequential order; Reconcilement of deposit balances; Analysis of suspense accounts; Audit trails for all accounting transactions; Proof of records by individuals not authorized to post them; Review of accounts by individuals other than the administrator assigned to them; Separate control over checks returned undelivered; Procedures for reissuance of returned checks; Mandatory vacation policy; and Record retention policy.

Examiners should realize that an effective system of personnel policies designed to effect dual control, duty separation and rotation is costly. Many trust departments are unprofitable measured by any standard and trust officers may resist implementation of expensive control measures. Examiners need to exercise judgement in assessing a department's control system. One or more basic points may have deficiencies, but the system may be strengthened by bolstering others. Often this is accomplished by reliance upon a strong audit, whether by an external CPA or an internal auditor.

Areas of Defalcation - While discovery of defalcations is not the primary objective of a trust examination, the examiner should be alert to practices which could permit or encourage them. A major factor contributing to defalcations in trust departments is exposure to temptation, usually resulting from shortcomings in the department's internal controls and audit programs. Following is a discussion of sensitive areas in trust department operations particularly susceptible to manipulation and abuse:

(1) Failure to record the receipt of asses when am counts are opened. The unwitnessed assembling of assets, particularly those of decedents' estates, is a dangerous practice. In such cases, detection of theft may be impossible since no record of a missing asset exists in the bank's files;

(2) Unauthorized and forged withdrawals of cash and securities from accounts. Absence of effective dual controls makes such actions easy for the manipulator. One method is to transfer assets to an account under an embezzler's control. Once the assets are in this account, the individual is free to sell them for personal gain, use them in market speculation, or pledge them for personal loans;

(3) Conversion of payments received on securities believed to be worthless. A trust department's policy guidelines on worthless securities should include procedures to be followed when determining an asset's worth, a requirement that all assets deemed worthless be reported to the trust committee or other appropriate committee prior to being written off, and carrying of worthless assets at a nominal value either in the respective accounts, or a department suspense account. This allows a constant audit trail to exist on the asset;

(4) Diversion of income on assets received in either irregular amounts or at irregular intervals. Such income is usually derived from royalties, oil wells and the like. Income from all investments should be internally controlled and audited with added attention given in those cases where investments fail to produce income. In this connection, several defalcations have occurred by diversion of payments of interest and principal on debt obligations previously in default;

(5) Falsification of expenses and misapplication of trust commissions and fees. Expenses and recurring fees present possibilities for manipulation. It should be bank policy that expenses be accompanied by appropriate documentation. The trust administrator should not have control or access to expense checks. Similarly, adequate internal safeguards should exist to assure the crediting of trust commissions and fees to the appropriate income accounts;

(6) Manipulation of payments received on rental properties, real estate and real estate mortgages. Administration of these trust properties frequently involves handling cash payments received in the department by personal deposit or through the mails. Unless good internal controls are in effect, defalcations through overlapping or withholding of payments could occur;

(7) Improper use of suspense accounts. It is frequently found that suspense accounts in trust departments are not governed by good internal control procedures and unauthorized settlements or disbursements could easily occur; and

(8) Misuse of corporate bonds, notes and stock certificates in the bank's possession because of a corporate agency relationship. Inventories of unissued securities not under effective control could be stolen and used as collateral for loans. Securities remitted for payment or transfer not properly controlled could be used for the same purpose.

The above is a partial listing of potential areas that might involve trust department defalcation. Management's most effective means of preventing defalcations is a system of comprehensive internal controls and a good internal audit program. The

examiner's role is to promote their installation and maintenance.

J. AUDITS

Every institution should develop a written audit program approved by the board or audit committee thereof. The program should be geared to the type of business transacted and take into consideration the experience level of those required to implement it as well as frequency of performance. Vague references to the conduct of various phases of the audit should be avoided in favor of a step-by-step approach. In addition, management should be encouraged to consider coordinating or integrating its internal audit function with the annual directors' examination. Careful planning in this direction will result in both better audits and increased efficiency.

In reviewing the bank's internal audit program the examiner should expect to find the following minimum functions being performed: Review of trust committee minutes; Balance and proof subsidiary ledgers to general controls; Asset confirmations; Spot-check and tracing of transactions for accuracy and validity; Review of commission and fee calculations; Review for compliance with applicable regulations; Review of internal routine and controls; and Administrative review of selected accounts comprised of state trust agreement and court orders, administrative actions (in compliance with above), income receipts, income distributions, principal invasions (including approvals therefor), asset composition and conformity with indenture, consultation with co-fiduciaries, and approvals by co-fiduciaries.

K. ELECTRONIC DATA PROCESSING

The advent of trust automation has enabled banks to reduce their staffs while increasing efficiency and productivity. Moreover, the capacity and speed of data processing equipment have enabled trust management to produce a variety of analytical reports with minimum effort. This capability allows management to service a greater number of accounts without sacrificing administrative quality.

There are a number of avenues which may be selected when converting to an automated system. Each has its own benefits and disadvantages which must be evaluated by management relative to the unique qualities and requirements of its department.

The first approach to automation is conversion to the computer used by the commercial department of the bank. However, this method could prove cumbersome. Under this approach, the department would be limited to the equipment and programming resources of the bank. It would also be one of several departments on the bank's computer which could produce delays in processing time. Also, since trust applications are unique, costly programming time will be required to create appropriate software packages.

Another method for conversion is to purchase a small computer for the department's sole use and obtain software packages marketed by computer manufactures or firms which specialize in creating software for industry. The disadvantage to this approach is that the department might well outgrow its equipment or software and have to convert to a larger system.

The remaining and most common approach to automation involves utilizing the services of firms which specialize in trust account servicing. In this situation, the servicer provides all equipment and software. The department is able to take advantage of the size and resources of the servicer in terms of back-up equipment, high speed and capacity of the computers used, experience and expertise in trust automation, and the ability to provide continuous software improvements via a full-time programming staff.

In its selection process, management will have to consider the following: Volume and character of business transacted; Projected growth and future needs; Experience and expertise of the servicer (in-house or outside); Ability of computer system to grow with the department; Financial stability of outside servicer; Back-up equipment; Back-up data, i.e., the ability to reconstruct records if primary data is lost; Internal controls and capability of internal audit department; Cost effectiveness of conversion; and Operational standards and procedures of servicer.

L. EXAMINATION PROCEDURES

The following outline of examination procedures may be used as a guide in assessing a trust department's systems for operations, controls and audits. Examiners should not consider this list all-inclusive, nor will all these procedures be necessary in every department. Examiners must take into consideration the complexity and size of the department as well as the staff available in determining the scope of each examination.

(1) Where a department is on a manual system of recordkeeping, all subsidiary records should be proved to their control accounts.

(2) If the department is using a computerized system, the following printouts should be requested; cash held by account, assets held by account, trial balance of accounts by account type, a list of accounts holding own-bank stock, Statement of Condition, list of overdrafts (may be included in cash listing), and list of common trust fund participants.

(3) If a securities count is to be performed, control should be established over all assets in the vault and a list made of all items pending deposit into the vault. Assets should then be checked to the subsidiary ledgers. All assets held outside the department should be verified by direct confirmation.

(4) When performing the vault count, a review should be made of vault controls in use. All bank's, regardless of size, should keep trust assets separate from bank assets and under a system of dual control. It is also recommended trust departments maintain a vault log and a vault ticket system to control securities movements.

(5) Verify principal and income cash by reconciling the combined total to the figure shown on the bank's general ledger (commercial). If the bank maintains a separate demand account for the trust department, a cut-off statement should be requested. When reconciling cash, trust checks outstanding should be reviewed for stale items. Also included should be a review for compliance with bank policy on dual signatures.

(6) A review should be made of all overdrafts giving particular attention to larger and longstanding items. A determination should be made as to why they exist and how they will be eliminated. Allowance should be made for permissible income/principal offsets.

(7) A review should be made of large cash balances. Similarly, older items should be given particular scrutiny. In most cases uninvested principal cash balances are of primary importance. However, if there are any large income cash balances on hand due to the absence of regular distributions, they should be discussed with management.

(8) A review should be made of the department's tickler system making note of the type of items it contains. When performing administrative reviews, the extensiveness of the tickler system can be checked on an account by account basis.

(9) A review should be made of the department's

"house accounts" and "suspense accounts". A determination should be made of their purpose and use. Large and stale items should be thoroughly investigated.

(10) A determination should be made as to the effectiveness of the bank's system of obtaining and following up on co-fiduciary and grantor approvals.

(11) A determination should be made as to the effectiveness of the bank's policies for preparing accountings when formal court accountings are not required. Accounts of the type which have not had an accounting prepared for a period exceeding 15 months should be discussed with management. The discussion should center upon the department's ability to retrieve stale records and whether or not it is advisable for the department to prepare accountings on a recurring basis.

(12) Review should be made of the department's filing system to determine if information contained therein is well organized and readily accessible. Original agreements should be held in fireproof cabinets. If the bank's files are not fireproof, the original agreements should be stored in the vault with a working copy held in the administrative file.

(13) An analysis should be made of departmental policies and practices in regard to segregation of duties and capability of any person to have sole control over any particular transaction or account.

(14) Obtain from the bank's internal auditor (if applicable) a copy of the current internal audit program, frequency schedule and corresponding workpapers.

(15) In some departments the entire audit program will be performed once each year. In other departments different portions of the audit may be performed more frequently (monthly, quarterly, etc.). Determine if the frequency schedules as approved by the bank's board are being followed.

(16) Review corresponding work papers to verify that all portions of the audit and outlined procedures are being performed.

(17) Review criticisms and exceptions cited by the internal auditor to determine if they have been corrected.

(18) Obtain a copy of the bank's external (CPA) audit of the trust department to analyze its and frequency. Determine whether it conforms to state requirements, if any.

(19 Review the areas covered by both the internal and external auditors (if applicable) to determine their adequacy. The size, complexity and type of business conducted should be taken into consideration when making this determination.

(20) Review the last audit of the common trust funds normally performed by an outside CPA firm.